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Federal Communications Commission
Office of the Secretary

RM 7626

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

The Allowance For Funds Used During Construction (AFUDC) Rate Properly Charged By Dominant Carriers For Ratemaking and Other Purposes

# PETITION FOR RULEMAKING

The Ameritech Operating Companies,[1] pursuant to Section 553 of the Administrative Procedure Act (5 U.S.C. § 553) and Section 4(i) of the Communications Act of 1934 as amended (47 U.S.C. § 154(i)), respectfully petition and request that the Commission modify its existing rule that the "compound prime rate of interest be used for accruing AFUDC [Allowance for Funds Used During Construction]" to provide that the Commission's most recently authorized or prescribed rate of return will be the rate used for accruing AFUDC. In support of this petition, the Ameritech Operating Companies respectfully represent that:

1. Section 32.2000(c)(2)(x) of the Commission's Rules provides that "'Allowance for funds used during construction' includes the cost of debt and equity funds used in the

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1. The Ameritech Operating Companies are Illinois Bell Telephone Company, Indiana Bell Telephone Company, Incorporated, Michigan Bell Telephone Company, The Ohio Bell Telephone Company, and Wisconsin Bell, Inc.

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construction of telecommunications property and shall be applied" to property in Account 2004, Telephone Plant Under Construction-Long Term. 47 C.F.R. § 32.2000(c)(2)(x). Thus, as Section 32.200(c)(2)(x) explicitly recognizes and the D.C. Circuit recently observed, "AFUDC is intended to compensate investors for the use of their funds during construction" when, as under the Commission's rules, plant under construction (long term) is excluded from the rate base. *Illinois Bell Tel. Co. v. FCC*, 911 F.2d 776, 782 (D.C. Cir. 1990).

2. The prime rate -- the Commission's current AFUDC rate for ratemaking purposes -- does not fully compensate investors for the use of their funds during construction. Telephone companies use a combination of debt and equity to finance construction projects. That means the AFUDC rate needs to be set at the current, overall cost of capital to compensate investors fully for financing construction projects. As the D.C. Circuit reminded ratemaking agencies several years ago, investors are entitled to a full return on capital devoted construction:

> A regulated utility is, of course, entitled to recover the cost of financing the construction of facilities . . . . The "cost" includes interest on debt and a reasonable return on capital investment.[2]

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2. *Mid-Tex Electric Cooperative, Inc. v. FERC*, 773 F.2d 327, 330-31 (D.C. Cir. 1985).

As the prime rate is lower than the minimum reasonable overall cost of capital, investors are denied an opportunity to recover their cost of capital even on a deferred basis.

**BACKGROUND**

3. The Commission initially adopted the "prime rate" as the AFUDC rate for ratemaking purposes in Docket No. 19129. *AT&T - Charges for Interstate Services*, 64 F.C.C.2d 1 (1977), *recon.*, 67 F.C.C.2d 1429 (1978) (*Docket No. 19129*). The use of the prime rate was predicated on the Commission's express finding that AT&T could finance its construction program with short-term debt, which AT&T was able to borrow at the prime rate. *Docket No. 19129*, 64 F.C.C.2d at 59-60 ¶ 150. That decision was not appealed.

4. Applying essentially the same rationale, the Commission adopted the prime rate as the AFUDC rate in its 1977 *Comsat* rate decision; that decision was appealed and the Commission's use of the prime rate was remanded. *Communications Satellite Corp. v. FCC*, 611 F.2d 883, 895-97 (D.C. Cir. 1977) (*Comsat*). In *Illinois Bell*, the FCC correctly characterized the Court's *Comsat* ruling as requiring the Commission to use its best "'judgment as to the most

realistic assumption' about the source of capital" in selecting an AFUDC rate.[3]

5. After the *AT&T* rate case and the AT&T divestiture, the Commission mechanically continued to use the prime rate as the AFUDC rate for local exchange carriers. That use has gone unexamined. In the recent Rate Base rulemaking, for example, the Commission took the position that the AFUDC rate was not properly at issue in the proceeding.[4] In doing so, the Commission refused to consider the unrefuted evidence that telephone companies finance their construction programs using a combination of debt and equity.

6. The D.C. Circuit refused to disturb the FCC's non-merits ruling. *Illinois Bell*, 911 F.2d at 782-83. The Court did, however, remind the telephone companies that they could file a petition for rulemaking if they "want[ed] the Commission to reconsider the rationale underlying its use of the prime rate for AFUDC generally...." *Illinois Bell*, 911 F.2d at 783.

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3. *Illinois Bell Tel. Co. v. FCC*, No. 88-1175 (D.C. Cir.), FCC Brief (filed Dec. 21, 1989) at 32, quoting *Comsat*, 611 F.2d at 895.

4. *Amendment of Part 65 of the Commission's Rules to Prescribe Components of the Rate Base and Net Income of Dominant Carriers*, 3 FCC Rcd 269, 273 ¶ 32 (1987), *recon.*, 4 FCC Rcd 1697, 1703 ¶ 56 (1989).

**THE PROPOSED RULE**

7. The Ameritech Operating Companies request that the Commission modify Section 32.2000(c)(2)(x) of the Commission's Rules, 47 C.F.R. § 32.2000(c)(2)(x), to specify that the AFUDC rate for a local exchange carrier shall be the most recently Commission-authorized or Commission-prescribed overall return for that carrier. As envisioned by this petition, the new Section 32.2000(c)(2)(x) would read (<u>underscoring</u> indicates revised text):

> (x) "Allowance for funds used during construction" includes the cost of debt and equity funds used in the construction of telecommunications property and shall be applied to telecommunications property designed to be completed in over one year as described in § 32.2004 of this subpart. Allowance for funds used during construction shall be charged to the accounts appropriate for the cost of the property acquired or constructed as follows:
> (A) <u>The most recently authorized or prescribed overall rate of return established by the Commission for the company</u> during the construction period (before the property is received or is completed ready for telecommunications service) on general funds expended for any acquisition or construction of telecommunications plant shall be computed on amounts in Account 2004, Telecommunications Plant Under Construction-Long Term and shall be charged thereto. Such amounts shall be credited to Account 7340, Allowance For Funds Used During Construction.

8. To reflect the policy of including the full amount of all accumulated AFUDC in the carrier's rate base for ratemaking purposes, the Ameritech Operating Companies also request that the Commission modify Section 65.820(a) of its Rules, 47 C.F.R. § 65.820(a), to provide as follows:

**§ 65.820 Included Items**

(a) *Telecommunications Plant.* The interstate portion of all assets summarized in Account 2001 (Telecommunications Plant in Service) including allowances for funds used during construction computed in accordance with Account 2000(c)(2)(x), and Account 2002 (Property Held for Future Use), net of accumulated depreciation and amortization, and Account 2003 (Telecommunications Plant Under Construction-Short Term), and, to the extent such inclusions are allowed by this Commission, Account 2005 (Telecommunications Plant Adjustment), net of accumulated amortization.

**DISCUSSION**

9. Setting the AFUDC rate at the prime rate is inconsistent with how telephone companies fund construction projects, the governing legal standard, and the Commission's policy of encouraging carriers to reinvest their earnings in their regulated businesses. Using the prime rate under current circumstances ignores the actual sources of capital that telephone companies use to finance construction projects.

10. Over the past few years, the construction programs of the Ameritech Operating Companies have been in the $2 billion range. The average annual amount reflected in Account

2004 (Telecommunications Plant Under Construction -- Long Term) for the Bell Operating Companies has ranged from $931 million to $1.8 billion over the past four years:

**Account 2004 - TPUC Long Term**[5]

| | $000,000 | | | |
|---|---|---|---|---|
| | 1986 | 1987 | 1988 | 1989 |
| Ameritech Telcos | $304 | $207 | $144 | $130 |
| Bell Atl. Telcos | 167 | 112 | 115 | 137 |
| BellSouth Telcos | 258 | 230 | 88 | 97 |
| NYNEX Telcos | 376 | 387 | 350 | 309 |
| PacTel Telcos | 229 | 115 | 77 | 98 |
| S.W.Bell Telcos | 241 | 139 | 71 | 63 |
| U S West Telcos | 265 | 122 | 86 | 127 |
| Total | $1,840 | $1,312 | $931 | $961 |

11. With respect to the Ameritech Operating Companies, the source of funds to finance their construction programs has been a combination of debt and equity. Specifically, since divestiture, the Ameritech Operating Companies' long term construction programs have been financed internally through a combination of depreciation (approximately 40% debt, 60% equity) and retained earnings (100% equity) and, to a lesser extent, investment tax credits (equity) and deferred taxes.

5. The 1986 and 1987 data were calculated from Schedule 11 of the Annual Form M Reports. The 1988 and 1989 data were taken from Schedule B-1 of the Annual Form M Reports.

**SOURCES OF LONG-TERM CONSTRUCTION FUNDS**
(Ameritech Operating Companies)

| | 1986 | 1987 | 1988 | 1989 |
|---|---|---|---|---|
| Depreciation | 84.73% | 90.14% | 97.03% | 96.68% |
| Retained Earnings | 6.36 | 6.58 | 3.85 | 5.65 |
| New Equity | 0.58 | 0.63 | 0.00 | 0.00 |
| New Debt[6] | -2.46 | 6.94 | 1.68 | -1.85 |
| Other[7] | 10.79 | -4.27 | -2.56 | -0.48 |

12. The Ameritech Operating Companies appear to be typical of the industry. For example, in CC Docket No. 86-497, Pacific Bell observed that it "funds all [construction] projects from its overall capital structure." [8]

13. Moreover, to the extent that short term borrowings may be used to fund construction projects, those borrowings and the associated cost (interest rate) are reflected in the capital structure and debt cost used by the Commission in establishing a reasonable overall rate of return. *See* 47 C.F.R. § 65.301 (computing embedded cost of debt).

14. Against these facts, use of the prime rate rather than the overall rate of return is inconsistent with the

6. New debt includes both long term and short term debt. A negative number indicates that more debt was paid off than taken on during the year.

7. The other category includes investment tax credits (which are in the process of being written off), deferred taxes, and miscellaneous changes in working capital.

8. Comments of Pacific Bell in Support of Petitions For Reconsideration (filed March 23, 1988) at 11.

purpose of AFUDC as articulated by both this Commission and the courts. In its brief to the court in *Illinois Bell*, the Commission states the "purpose of AFUDC [is] 'to compensate investors for the full cost of construction . . . ..'"[9] The D.C. Circuit agreed: "AFUDC is intended to compensate investors for the use of their funds during construction."[10]

15. The "full cost" is, of course, the cost of capital incurred by the telephone company to finance construction projects. That cost, in light of how telephone companies actually finance construction programs, is the telephone companies' overall rate of return.[11]

16. There is another reason why the Commission should use the overall rate of return: Continued use of the prime rate is inconsistent with the Commission's policy of encouraging carriers to invest in the telecommunications infrastructure.

17. As the court reviewing an ICC rate of return rulemaking decision pointed out:

> [The carrier's management] has little incentive to reinvest [internally generated funds in the regulated business] if greater returns are available elsewhere. . . . [R]etained

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9. FCC Brief at 31, quoting *Rate Base Reconsideration Order*, 4 FCC Rcd at 1703 ¶ 56 (emphasis supplied).

10. *Illinois Bell*, 911 F.2d at 782.

11. The alternative is to include Account 2004 (PUC-long term) in the rate base. That alternative will result in lower rates for both current and future ratepayers. *See* Attachment A.

> earnings will not be invested in the company if they cannot earn a rate of return equal to the cost of capital.[12]

The same reasoning applies to the funds required to finance plant under construction.

**CONCLUSION**

For the foregoing reasons, the Ameritech Operating Companies request that the Commission publish a notice of proposed rulemaking which proposes to adopt as a rule the use of the carrier's overall rate of return as the AFUDC rate for ratemaking purposes and, after receiving comments on that notice, adopt the proposed rule.

Respectfully submitted,

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January 11, 1991

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12. *Bessemer & Lake Erie R.R. Co. v. ICC*, 691 F.2d 1104, 1111 (3rd Cir. 1982).

ATTACHMENT A

The telephone companies' comments in this proceeding identified several reasons why the exclusion of plant under construction-long term (Account 2004) from the rate base disadvantages ratepayers over the long term. The two major reasons, both of which stand unrefuted, are:

1. Capitalization of financing costs (AFUDC) results in higher rates for ratepayers over the life of the plant once it is placed in service. The rate base is larger and the revenue requirements are greater than if all plant under construction were included in the rate base at the time the investment is made. The table below compares the revenue requirement impacts of two scenarios -- first, excluding PUC-long term from the rate base, and second, including it:

REVENUE REQUIREMENT COMPARISON:[1]
INCLUDING v. EXCLUDING PUC
($000)

| | Exclude PUC-Long Term-Include AFUDC | | Include PUC-Long Term | |
|---|---|---|---|---|
| Years In Service | Average Rate Base | Rev. Req. | Rev. Req. | Average Rate Base |
| PUC-1 | $ 525 | $ 0 | $ 82 | $ 500 |
| PUC-2 | $1,628 | $ 0 | $ 245 | $1,500 |
| 1 | $2,202 | $ 475 | $ 419 | $1,950 |
| 2 | $2,084 | $ 572 | $ 494 | $1,800 |
| 3 | $1,852 | $ 534 | $ 462 | $1,600 |
| 4 | $1,621 | $ 497 | $ 429 | $1,400 |
| 5 | $1,389 | $ 459 | $ 396 | $1,200 |
| 6 | $1,158 | $ 421 | $ 364 | $1,000 |
| 7 | $ 926 | $ 383 | $ 331 | $ 800 |
| 8 | $ 695 | $ 345 | $ 298 | $ 600 |
| 9 | $ 463 | $ 307 | $ 265 | $ 400 |
| 10 | $ 232 | $ 269 | $ 233 | $ 200 |
| 11 | $ 58 | $ 125 | $ 108 | $ 50 |
| 12 | 0 | 0 | 0 | 0 |
| TOTAL REVENUE REQUIREMENTS: | | $4,388 | $4,126 | |

1. The table is based on the following assumptions: (a) the investment is incurred at mid-year and the PUC-long term is transferred to plant in service at the mid-point of Year 1; (b) the AFUDC rate is 10%; and, (b) the annual revenue requirement is based upon an 11.25% overall rate of return, a 40% tax rate, a 40% debt/60% equity capital structure, a 9% cost of debt, and a 12.75% cost of equity. The revenue requirement is the annual depreciation + 16.35% (pre-tax cost of capital) times the rate base. The 16.35% factor is based on an equity component of (12.75% X 60%) / (1-.4) = 12.75%; the debt component is 9% X 40% debt ratio = 3.6%. 12.75% + 3.6% = 16.35%.

Under current circumstances, as documented in the table, ratepayers will pay 8% more over the ten year life of the investment. When one takes into consideration the billions of dollars expended on construction projects each year, 8% is a significant amount.

2. Excluding plant under construction increases the cost of capital. First, capitalizing financing costs, rather than including all PUC in the rate base, has a significant negative effect on a carrier's cash flow and coverage ratio. Second, capitalizing financing costs exacerbates the telephone company's existing capital recovery problem by adding an additional amount to the depreciable rate base and thus, potentially, to the existing reserve deficiency. All of this in turn adversely affects bond ratings and the equity investors' perception of risk, thereby increasing the cost of capital.

As the Supreme Court underscored in *Duquesne*,[2] any increased risk caused by the regulatory exclusion of prudently invested capital from the rate base must be compensated for by the regulatory body in setting any "authorized" rate of return -- a fact FCC counsel conceded before the D.C. Circuit Court of Appeals in *Illinois Bell*. *See Illinois Bell*, 911 F.2d at 780. As the Ameritech Operating Companies pointed out in their submissions in the Commission's recent rate of return case (CC Docket No. 89-624), the disallowances contemplated by the

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2. *Duquesne Light Co. v. Barasch*, 109 S. Ct. 609 (1989).

Commission's rules currently justify a twenty basis point increment in the authorized rate of return. If that disallowance compensation factor is included in the calculations in the above table, the detriment to the ratepayer occasioned by the exclusion of plant under construction increases approximately 15% -- from $262,000 (using the table on page A-2) to $303,000. See Attachment A-1.

3. In effect, the Commission told the *Illinois Bell* Court that increasing the current return applied to plant in service to reflect the additional risk occasioned by the disallowance of PUC-long term is reasonable, but including PUC-long term in the rate base and avoiding altogether that risk increment to the current return is not reasonable. Nowhere has the Commission explained why ratepayers are better off paying higher rates today (to reflect the additional risk factored into the current return) and higher rates tomorrow (to cover the additional costs occasioned by reflecting accumulated AFUDC in the rate base).[3]

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3. The FCC's indifference about the level of telephone company capital costs was clearly illustrated in its discussion of PUC-long term: There, the FCC agreed that the telephone companies "have not shown a need for relief in reducing their financing costs." *Rate Base Order*, 3 FCC Rcd at 272 ¶ 30 (emphasis supplied).

Attachment A-1

REVENUE REQUIREMENT COMPARISON:[4]
INCLUDING v. EXCLUDING PUC
($000)

| Years In Service | Exclude PUC-Long Term-Include AFUDC: Average Rate Base | Exclude PUC-Long Term-Include AFUDC: Rev. Req. | Include PUC-Long Term: Rev. Req. | Include PUC-Long Term: Average Rate Base |
|---|---|---|---|---|
| PUC-1 | $ 525 | $ 0 | $ 82 | $ 500 |
| PUC-2 | $1,628 | $ 0 | $ 245 | $1,500 |
| 1 | $2,202 | $ 483 | $ 419 | $1,950 |
| 2 | $2,084 | $ 579 | $ 494 | $1,800 |
| 3 | $1,852 | $ 540 | $ 462 | $1,600 |
| 4 | $1,621 | $ 502 | $ 429 | $1,400 |
| 5 | $1,389 | $ 463 | $ 396 | $1,200 |
| 6 | $1,158 | $ 425 | $ 364 | $1,000 |
| 7 | $ 926 | $ 386 | $ 331 | $ 800 |
| 8 | $ 695 | $ 347 | $ 298 | $ 600 |
| 9 | $ 463 | $ 309 | $ 265 | $ 400 |
| 10 | $ 232 | $ 270 | $ 233 | $ 200 |
| 11 | $ 58 | $ 125 | $ 108 | $ 50 |
| 12 | 0 | 0 | 0 | 0 |
| TOTAL REVENUE REQUIREMENTS: | | $4,429 | $4,126 | |

4. The table is based on the following assumptions: (a) the investment is incurred at mid-year and the PUC-long term is transferred to plant in service at the mid-point of Year 1; (b) the AFUDC rate is 10%; and, (b) the annual revenue requirement is based upon an 11.45% overall rate of return, a 40% tax rate, a 40% debt/60% equity capital structure, a 9% cost of debt, and a 13.08% cost of equity. The revenue requirement is the annual depreciation + 16.68% (pre-tax cost of capital) times the rate base. The 16.68% factor is based on an equity component of (13.08% X 60%) / (1-.4) = 13.08%; the debt component is 9% X 40% debt ratio = 3.6%. 13.08% + 3.6% = 16.68%.